This record is a partial extract of the original cable. The full text of the original cable is not available.

C O N F I D E N T I A L SECTION 01 OF 05 CARACAS 002934

SIPDIS

NSC FOR CBARTON
ENERGY FOR CDAY, DPUMPHREY, AND ALOCKWOOD

E.O. 12958: DECL: 08/11/2015
TAGS: EPET EINV VE
SUBJECT: GOV HYDROCARBON POLICY: UNDERLYING ASSUMPTIONS

REF: A. CARACAS 02387
¶B. CARACAS 02443
¶C. CARACAS 02596
¶D. CARACAS 02807

Classified By: Economic Counselor Andrew Bowen for Reason 1.4 (D)

SUMMARY

¶1. (C) GOV hydrocarbon policy is driven by ideology, oil prices, and, to a lesser extent, production levels. The basic contours of the GOV's hydrocarbon policy are the maximization of state control over reserves, the maximization of state revenues, and the use of oil as a significant tool in advancing the GOV's foreign policy goals. Whenever there is a collision between these goals, the maximization of revenues is the first objective to go by the wayside. President Chavez appears to believe oil prices will not only stay high but continue to climb. Even assuming he is correct, we believe the GOV will face declining production levels in the short to medium term. The decline stems from three broad factors: inadequate maintenance, a decline in PDVSA's administrative abilities, and a degradation of PDVSA's and, to a certain extent, the private sector's operational abilities It is not clear at what point the decline will start to squeeze the GOV fiscally. Septel will cover Post's views on GOV options if the decline begins to cause fiscal problems, including the possible role of IOCs. END SUMMARY.

WHAT IS GOV HYDROCARBON POLICY?

¶2. (C) The basic contours of the GOV's hydrocarbon policy are the maximization of state control over reserves, the maximization of state revenues, and the use of oil as a significant tool in advancing the GOV's foreign policy goals. The GOV intends to maximize its control over reserves in part by forcing migration of companies with operating service agreements (OSAs) to mixed or joint venture companies in which PDVSA will have majority control by the end of the year (See Reftel A). The GOV's goal, as reported in Reftel B, appears to be the conversion of all of the OSAs, the four strategic associations, and the exploration contracts into joint venture companies, with PDVSA exercising control. The resulting joint ventures would be subject to a 30 percent royalty rate and a 50 percent income tax rate. The GOV will also maximize its control over reserves by ensuring under its "Siembra Petrolera" strategic development plan that new oil projects will be controlled by PDVSA and in many cases involve national oil companies (NOCs) from countries friendly to the GOV (Reftel C).

¶3. (C) The GOV has attempted to maximize state oil revenues by claiming companies with OSAs owe substantial back taxes and are subject to a 50 percent tax rate rather than a 34 percent rate (Reftel D). Both the maximization of state control and revenues are in line with Ministry of Energy and Petroleum (MEP) Vice Minister Bernard Mommer's books and articles. Mommer is personally leading the negotiations to migrate the OSAs to joint venture agreements. The GOV, under its Petroamerica program, has aggressively used sweetheart oil deals to increase its influence in the Caribbean, Central, and South America.

¶4. (C) COMMENT: It is obvious that the three main prongs of GOV hydrocarbon policy directly collide with each other. Whenever there is a collision, the maximization of revenues is the first objective to go by the wayside. Sweetheart oil deals such as Petrocaribe have a direct impact on the bottom line. In addition, the uncertainty the GOV has raised by ignoring the sanctity of contracts has had an impact on foreign investment in the sector. That said, Venezuela, with its huge reserves, is too rich a prize for IOCs and NOCs to abandon. END COMMENT

PRICE, RESERVES, AND IRRATIONAL EXUBERANCE

¶5. (C) Although the GOV's hydrocarbon policies are not economically efficient or rational at first glance, they are not illogical if you make certain basic assumptions. If you

assume that oil prices will only continue to go up, then the maximization of revenues and production are not as key as they normally would be. This is particularly true if the GOV's political goals of reordering society and expanding its influence in the hemisphere are considered to be more important than economic goals. If oil prices are high and continue to rise, then the GOV does not have to worry as much about inefficiencies in PDVSA or even declines in production. Rising oil prices will still continue to provide the GOV with sufficient levels of income for its social programs and foreign policy objectives.

¶6. (C) President Chavez has stated publicly that he believes prices will continue to rise for a number of reasons (Reftel C). The obvious question is whether he really believes it. The answer appears to be yes. Dr. Hugo Hernandez (strictly protect), President of Constructores Electricos Industriales, an oil services company, and a PDVSA external director until January 2005, told Petroleum Attache (PetAtt) that he had a conversation with Chavez approximately seven months ago. Chavez was firmly convinced that oil prices could only rise in the future. He based his view on increased world demand, Saudi Arabian production capacity, and his belief that the United States would draw down the SPR. When Hernandez pointed out that ever increasing oil prices flew in the face of history, Chavez remained unconvinced. Hernandez believes Chavez's advisors have convinced him that prices can only go one direction in the foreseeable future: up. (COMMENT: Hernandez is a rarity in present day Venezuela: a realist who has managed to maintain excellent ties with both the GOV and the opposition. An attorney by training, he sat on the commission that drafted the current hydrocarbon law. His departure from the PDVSA board does not appear to be the result of a rift with the Chavez administration, but rather to the expiration of his term. He told PetAtt that he never wanted to sit on the board in the first place. Hernandez's service company counts both PDVSA and Chevron as major clients. END COMMENT)

¶7. (C) The other key assumption that the Chavez administration is making is that Venezuela's reserves, combined with high prices, basically put the GOV in the driver's seat when it comes to dealing with the IOCs, NOCs, and service companies. This assumption has a great deal of merit to it. As Chavez noted in his Siembra Petrolera speech this month, the Faja region of Venezuela contains reserves of 236 billion barrels. Although these reserves are heavy or extra heavy in nature, advances in technology have made the development of the Faja commerically feasible. Ali Moshiri, President of Chevron Latin America Upstream, told Economic Counselor (Econcons) and Petatt on September 23 he believes the Faja has the potential to be a "Saudi Arabia type" development. According to Moshiri, the Faja could have a production level of 1.5 million barrels per day within five years if it were developed correctly. Moshiri said it is hard to find another major development that has less political risk. In addition, no other potential major development has Venezuela's geographic advantages. According to Moshiri, the Faja offers the possibility of relatively low cost production and low transportation costs. In addition, there is no question that the petroleum is actually there. Moshiri noted it was only a question of "punching holes". He also noted Venezuela, despite all of the recent problems, still gave Chevron its highest profit margins in the world. To put it simply, Venezuela's reserves make it too important for IOCs or NOCs to ignore. As service company executives recently pointed out to Econcons and Petatt, the GOV knows that even if 2 or 3 IOCs or NOCs leave Venezuela, it will still have close to 30 companies that are willing to stay.

THE KEY IS PRODUCTION

¶8. (C) Assuming the GOV's assumptions about production and companies' willingness to stay in Venezuela, come what may, in order to have access to reserves are true, the one factor that could be the GOV's Achilles heel is production. Obviously, you have to extract hydrocarbons from the Earth in order to take advantage of high oil prices. Although the new Faja blocks offer an incredible opportunity for the GOV and oil companies, they will not begin producing for at least five years. In addition, Moshiri specifically noted the blocks have to be developed properly if they are to produce 1.5 million barrels a day. The key questions are what is PDVSA's ability to produce presently and is that ability degenerating.

¶9. (C) Although PDVSA is currently claiming a daily production level of 3.3 million barrels, conventional wisdom among our private sector contacts is that production is hovering between 2.4 to 2.6 million barrels. Of this amount, IOCs account for 1.2 million barrels, or roughly 45 percent. Chevron's Moshiri believes the IOCs could easily raise their production level to 1.5 million barrels a day with little or no additional investment. He also believes that production is currently between 2.6 to 3.0 million barrels. Former

PDVSA director Hernandez told PetAtt he saw internal PDVSA documents that showed production of 3.0 to 3.1 million barrels. (Comment: Hernandez harshly criticized PDVSA throughout his discussion with PetAtt. It is hard to believe that he would exaggerate production figures given the rest of his comments. End Comment) Moshiri has an explanation for the divergent figures that makes sense. He stated PDVSA production figures have fluctuated on a daily basis. He believes PDVSA lower management regularly highlights high production figures and downplays poor figures. This would explain Hernandez's firm belief that PDVSA is producing 3.0 million barrels a day. It also raises the question of whether senior PDVSA and GOV officials are receiving true production figures.

¶10. (C) Conventional wisdom also holds that PDVSA production is declining. PetAtt has yet to speak to anyone in the industry outside of the GOV or PDVSA who does not believe that PDVSA production is declining. Production declines are due to three broad factors: inadequate maintenance, a serious decline in PDVSA's administrative abilities, and a sharp decline in PDVSA's and to a certain extent the private sector's operational abilities.

MAINTENANCE PROBLEMS

¶11. (C) According to generally accepted wisdom, Venezuelan production capacity falls by 20 to 25 percent per year. This decline is due to the heavy nature of Venezuelan crude as well as the age of many of the wells. As a result of these two factors, producers must use gas or steam injection in order to bring the crude to the surface. This requires constant maintenance on the part of operators. Private sector experts have been unanimous in stating that PDVSA has not carried out the necessary maintenance to maintain production levels let alone increase them. In addition, numerous contacts have stated they believe the reservoirs in Lake Maracaibo and in the East are in poor shape due to inadequate maintenance by PDVSA. Even Moshiri, who is generally an optimist, has stated the reservoirs are in poor condition. He went so far as to state PDVSA did not maintain the reservoirs even before the strike. If this is true, it is hard to imagine what condition they are in after the GOV fired 18,000 of PDVSA's most technically proficient employees.

--- ----
ADMINISTRATIVE CHAOS: MALEVOLENCE OR INCOMPETENCE
--- ----

¶12. (C) PDVSA's administrative problems start at the top and reach into every facet of the company's operations. Hernandez described PVSA as "ungovernable". He said there were numerus tensions within the board when he served as diector and they have only increased since his deparure. He said board members have reached the poin in meetings where they almost come to blows. Acording to Hernandez, the company has divided itelf into a series of cliques that war among themslves. He said approximately 30 percent of PDVSAemployees ar e "political". He said this was a conervative estimate and thought that it was closerto 50 percent. The remaining 50 percent of the mployees are resentful of the changes in PDVSA an sometimes engage in passive resistance. Hernandz said "problem employees" are frequently moved.
¶13. (C) Halliburton executives in Maracaibo toldEconcons and PetAtt they believe their biggest poblems are administrative in nature rather than oerational. The executives said they are not sur if PDVSA is making life difficult for them as part of a strategy or if it is just the result of incompetence. Service company executives in Maracaibo complained about constant turnovers among senior PDVSA managers and their frequent inability to find PDVSA managers who were willing to make basic decisions. PDVSA managers are often moved without warning and the executives complained they were frequently forced to start projects over again once an executive had been moved.

¶14. (C) A lack of legal expertise among PDVSA managers and attorneys has also created difficulties for service companies. Halliburton executives described PDVSA attorneys as "young, inexperienced, and radical". The executives said their biggest worry was contracts, particularly in the assignment of risk. PDVSA typically tries to use standardized contracts in all situations. This frequently translates into contracts that do not fit the unique demands of a project. For instance, PDVSA attorneys frequently ask for guarantees that would be appropriate for the construction of a warehouse but wholly inappropriate for an oil services project. Tenders have also caused companies problems. Several service company executives in Maracaibo said tenders frequently looked like cut and paste jobs from old contracts. In addition, companies often do not receive adequate information in order to draft rational proposals. Baker Hughes executives stated they repeatedly asked for detailed information on the Maracaibo Lake reservoir in order to make

a proposal. PDVSA refused to provide them with the information. The executives complained that PDVSA is becoming increasingly secretive. Mark Handin (strictly protect), general manager of Tidewater, a marine services company, said his company submitted tenders for the same project three times but the contract was never awarded. He blamed the situation on the fact that no one in PDVSA wants to make a decision.

OPERATIONAL PROBLEMS

¶15. (C) Conversations with private sector executives in Maracaibo indicate that operational problems can be traced to a lack of experience and training on the part of PDVSA personnel as well as labor problems. Oscar Romero (strictly protect), president of Wood Group Gas Turbines, said a senior PDVSA official stated 42 percent of PDVSA's work force had 3 to 5 years experience. According to Jose Toro Hardy, a former PDVSA director, the average level of experience before the strike was 15 years. Romero said PDVSA frequently sent an unusually large number of employees to supervise his firm's projects. It was clear that the additional personnel were being sent to Wood Group's shops in order to be trained. Wood Group employees were frequently required to explain all aspects of a job to the "supervisors". Wood Group now has a contract that includes a training component. Baker Hughes executives said they have not had any problems with radical PDVSA employees but said they were frequently inexperienced and asked to do projects well beyond their levels of competence. One of the executives speculated that PDVSA would have excellent engineers in five to ten years since the current crop of young engineers were being exposed to projects normally reserved for more senior engineers.

¶16. (C) New PDVSA labor regulations as well as increasingly radical "parallel" unions will also have an impact on production. PDVSA's new employment system, the Democraticization of Work System (SISDEM), which began on July 1, requires contractors and service companies to hire new employees for union jobs from a PDVSA employment pool. Pool operators select all of the new employees but the companies have a right to reject the selections. In addition, contractors that use union labor for specific projects will now have all of the jobs staffed by SISDEM employees. Under the previous system, the union in question selected 60 percent of the employees and the company selected 40 percent. The new system has caused tremendous difficulties for companies. Tidewater's Hardin said his company used to use their ability to select 40 percent o the workers to select key positions such as capain and chief engineer for their ships. Tidewate selected personnel who were certified and had rceived training from Tidewater. The company nowhas to worry about whether the personnel it entrsts with millions of dollars of equipment actuallyknow how to perform their jobs. Land service companies also have their share of problems. The biggest problem facing them at present is finding qualified drivers who know how to transport expensive equipment safely. One IOC executive based in Maracaibo said the time to transport a rig has increased from two to eight days as a result of SISDEM.
¶17. (C) New radical unions also appear to be a problem for companies. According to Romero, a radical, non-certified "union" came to his company in May and claimed to represent his work force The union bussed in outside agitators and chained the doors to his shop. The union made extravagant promises to the Wood work force and a portion of the employees backed the union. Romero used family connections to have the police come and reopen his shops. The overwhelming majority of his work force went back to work without causing problems but Romero believes that radical outside "unions" will become more active in the future and target international companies.

CONCLUSION

¶18. (C) Based on PDVSA's poor administrative controls, lack of technically capable operational personnel, poor labor regulations, as well as the effects these issues have on key contractors, we believe PDVSA's portion of Venezuelan hydrocarbon production will continue to decrease in the short to medium term. Despite the Faja's great potential, we do not believe that it will be developed with sufficient speed or skill to mitigate PDVSA's production decline. The question is not whether the production decline will have an impact on GOV finances but when. The answer to that question depends on both oil prices and the rate of decline. Septel will address the policy options the GOV has once production declines create pressure on the GOV budget.
Brownfield